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CHINA IN CENTRAL AND EASTERN EUROPE

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The Issue

The world's second largest economy and foreign investor, China's investments in Central and Eastern Europe (CEE) have grown in recent years as a share of overall European investment. While Europe's most developed economies will continue to attract the majority of Chinese funds in Europe, investment in CEE is nonetheless here to stay. The challenge: how should Europe create a coherent policy that addresses this new geopolitical reality?

INTRODUCTION

A few decades ago, few people foresaw that the People's Republic of China (PRC) would become the geopolitical and economic heavyweight that it is today. Following successful economic reforms in the late 1970s and its 1999 "Go Global" strategy, China had become the world's second largest economy and foreign investor after the United States by 2016, with foreign investments reaching $183 billion worldwide.[1,2,3,4] This rapid ascent is remarkable considering that Chinese foreign direct investment (FDI) was only $2.7 billion in total in 2002.[5]

With FDI, China targets specific regions for specific economic ends. When looking for markets and natural resources, China has invested in Asia, Africa, and Latin America. But when searching for advanced technologies, managerial knowledge, or distribution networks, China has favored the United States and Western Europe.[6] And as its economy grew and became more advanced, so did its investments in specialized markets, notably in Europe: from 2000 to 2016, the European Union (EU)-China FDI Monitor dataset recorded more than 1,400 individual FDI transactions by Chinese investors worth a combined €101 billion; and annual investment in the EU grew from less than €1 billion before 2008 to more than €35 billion in 2016.[7]

While more than half of these investments predictably went to Europe's most developed economies—Germany, France, and the UK—Chinese continental investments have become more geographically diverse in recent years. In particular, investments in Central and Eastern European (CEE) countries have gradually increased as a share of overall EU investment, totaling €46 billion or 8 percent of the PRC's total investments in Europe between 2000 to 2014.[8] So while China still invests heavily in the most advanced West European economies, it has also discovered new investment opportunities in the CEE region and has adjusted its investment allocation accordingly. For CEE and greater Europe, the challenge is to create a coherent policy response that addresses this new geopolitical reality.

THE RELATIONSHIP BETWEEN CHINA AND CEE

For the CEE countries, pursuing political and economic relations with China was not a strategic priority in the 1990s. Rather, their most important foreign policy goal was to join the European Union and NATO as soon as possible in order to guarantee their economic development and security.

Sino-CEE relations started to evolve only after the accession of eight CEE countries. During a June 2004 visit to Romania, Chinese President Hu Jintao stated that China would promote the development of mutually-beneficial friendly relations with CEE.[9] Regional Chinese investments then accelerated after the financial crisis hit Europe in 2008 and the region's countries began looking for alternative opportunities for economic recovery.[10] By 2012, intensified cooperation led to the establishment of the "16+1" cooperation among China and 16 CEE nations: 11 EU states (Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia) and five Western Balkan countries (Albania, Bosnia and Herzegovina, Macedonia, Montenegro, and Serbia), while each was also negotiating its accession to the EU.[11] Still in existence, the 16+1 framework focuses mainly on bilateral and multilateral initiatives on trade, investment, and transportation networks. It is also a part of China's global geopolitical and economic vision, the Belt and Road Initiative (BRI).

"Despite apparent ***economic convergence***, only a few CEE countries within the 16+1 have **actually succeeded in boosting economic relations** *with the PRC*."

Despite apparent economic convergence, only a few CEE countries within the 16+1 have actually succeeded in boosting economic relations with the PRC. Overall trade has grown visibly during the past few years—reaching $58 billion in 2016—although it is far short of coming close to the $100 billion goal of the 16+1. In addition, China's investment interests are not equal among CEE countries: trade is heavily focused on five markets—Czech Republic, Hungary, Poland, Slovakia, and Romania—which together comprise 80 percent of overall trade volume. Likewise, five countries have attracted 95 percent of China's FDI in recent years: Czech Republic, Hungary, Poland, Slovakia, and Bulgaria.[12] These trends clearly show that the four Visegrád countries (V4), namely the Czech Republic, Hungary, Poland, and Slovakia, are at the forefront of China-CEE trade relations and attract most of China's regional investments. But why is this the case?

THE PRC'S ECONOMIC PRESENCE IN THE V4 COUNTRIES

The economies of the V4 countries are the most advanced in CEE, but other factors also attract Chinese capital to the region. These include the size and presence of local Chinese communities; investment incentives and subsidies; the possibility of acquiring visas and permanent residency permits; privatization opportunities; the quality of political relations; and the governments' willingness to cooperate. Chinese regional investments are mainly motivated by market-seeking efforts, but Chinese businesses also look for brands and new technologies, which the V4 countries offer.

Chinese investments began flowing into the Czech Republic in 2005, reaching €568 million by 2016, according to Rhodium Group; CzechInvest ranks China among the country's top five foreign investors.[13] Leading Chinese companies are electronics manufacturers (Noark, Shanxi Yuncheng Plating Group, Changhong), IT companies (Huawei, ZTE), a maker of transport equipment (CITIC Marmes Bicycles), and a food producer (Shanghai Maling). Except for CITIC Marmes Bicycles—a joint venture—all the rest are greenfield investments. To date, China's largest investment project in the Czech Republic is a $330 million factory in the Nymburk Industrial Zone by LCD and LED TV manufacturer Changhong Europe Electric. Another top Chinese investor is Shanghai Maling Aquarius, which is establishing a factory in nearby Teplice.[14] The Bank of China (BoC) and the Industrial and Commercial Bank of China (ICBC)—both state-owned—are also present here, while the China Energy Company Ltd. (CEFC) has purchased shares in Czech Airlines, taken over Lobkowicz Breweries and bought a majority stake in the SK Slavia Prague soccer team.[15] During Xi Jinping's 2016 visit to Prague, the two countries signed a strategic partnership, as well as a package of investment memoranda and agreements worth €7.39 billion for the period 2016-20.[16,17]

Budapest started nurturing friendly relations with China in 2003.[18] According to Rhodium Group, China has invested €2 billion in Hungary since 2000.[19] More than 5,000 Chinese companies operate in Hungary, but most are small businesses in the service or retail sectors—restaurants, perfumeries, and so-called "Chinese shops." Hungary's biggest Chinese investors are Wanhua, Huawei, ZTE, Lenovo, Sevenstar Electronics Co., BYD Electronics, and Comlink.[20] Wanhua acquired full control over the Hungarian chemical company BorsodChem in a 2011 transaction worth $1.69 billion, and BBCA operates a citric acid factory in Szolnok.[21] In 2011, Xanga Investment Development Group acquired the license to operate Debrecen International Airport for "75+25 years."[22] The current flagship initiative of Hungarian-Sino cooperation is the $3.8 billion modernization of the rail link connecting Budapest and Belgrade, which aims to become the main transport route for Chinese goods arriving at the Greek port of Piraeus to other parts of Europe.[23] Chinese firms have invested heavily in port infrastructure in Greece, but CEE dreams of China using its Greek ports as gateways to develop the Balkan economy have so far failed to materialize.[24] China's top manufacturing multinationals have begun increasing their investments in the past few years and many (Lenovo, ZTE, Huawei) have turned their Hungarian businesses into the European hub of their activities.

Hungary's importance as a regional distribution center is evident when it comes to trade as well. Some big retailers and wholesalers, as well as business matching centers in Budapest—for example, Asia Center, China Brand Trade Center, Budapest Fashion Center, Budapest China Mart—support the distribution of Chinese and other Asian products in CEE and supply Hungarian customers as well. BoC has its CEE headquarters in Budapest, while ICBC and some of China's biggest law firms (Yingke, Dancheng) are also present.[25] Rather than greenfield investments, Chinese investors choose mergers, acquisitions, and joint ventures when investing there.[26] Yet despite Hungary's status as China's comprehensive strategic partner and its huge stock of Chinese direct investment, the country has not been able to attract a major new investor since Wanhua's 2011 acquisition of Borsodchem.[27]

In Poland, Chinese investments increased from $17.8 million in 2003 to $288.1 million by 2012.[28] By 2016, Rhodium estimates that Chinese investments had jumped to about €936 million.[29] About 700 Polish firms have Chinese capital, but as of 2011, 574 were small companies employing fewer than 10 people. Chinese investment in Poland focuses on electronics (TCL Corp., Victory Technology Polska, Chung Hong Electronics Poland, Digital View); electro-machinery (Nuctech); heavy machinery (LiuGong Machinery); publishing and printing (Haoneng Packaging); metals and metal products (Shanxi Yuncheng Platemaking Group); hospitality and real estate (Min Hoong Development Co., Sino Frontier Properties Ltd.); distribution of goods (GD Poland Investments Sp. z o.o.); and IT (Huawei, ZTE). The BoC and ICBC, as well as the law firms Yingke and Dacheng, also have offices there. In most of these cases, Chinese firms investing in Poland engage in greenfield investments.[30] Perhaps symbolic of their investment convergence, in 2015, Poland and China elevated their bilateral relations to the level of comprehensive strategic partnership.[31]

Lastly, in Slovakia, Chinese investments totaled €49 million between 2000-16.[32] The most important companies—SaarGummi, ZVL Auto, Inalfa Roof Systems, and Mesna—are in the automotive industry.[33] Investments include the Lenovo Operation Center for Europe, Middle East, and Africa (€5 million, 2006) and Mesnac's tire research center (2009). Rare examples of greenfield investments are the Flame Shoes' plant (€14 million, of which the Slovak government provided €4.5 million in 2014) and a production facility for large-scale display screens by Leyard Shenzhen Opto Electronics (€2.3 million in 2016).[34] The other IT giant, Huawei, is also present.[35] CEFC entered the Slovak market too, acquiring a majority stake in the J&T Finance Group, Slovakia's largest investment firm.[36,37]

THE IMPACT OF CHINA'S INCREASED ECONOMIC PRESENCE

So far, China's increased investment presence has not delivered strong economic benefits across the CEE region as a whole. One reason is that the 16+1 has a secretariat in the Chinese Foreign Ministry, but it does not coordinate the PRC's policies towards CEE.[38] So although the 16+1 aims to boost China's multilateral cooperation with CEE, it is more like a series of bilateral relationships with no overall coherence.[39] The PRC mostly engages with V4 countries, meaning China has as yet not established a common 16+1 policy.

In the context of China's entire global investment portfolio, the CEE region is a small part. According to the UN's Trade and Development Conference, only 2.7 percent (about $5 billion) of China's $183 billion in outward FDI went to the CEE region in 2016. China's investments in CEE were between $6 billion and $8 billion in 2016, with 95 percent going to the V4 and Bulgaria, according to the Chinese Ministry of Commerce. With regards to trade, the situation is similarly uneven: the V4 and Romania account for 80 percent of all trade between China and 16 CEE countries. Curiously, China-CEE trade increased much faster before the 16+1 partnership was institutionalized in 2012. Between 2009 and 2012, overall trade volume grew from $32 billion to $52 billion, but then increased only $6 billion by 2016. And although trade has objectively increased in the last decade, the trade balance is heavily tilted in favor of China, a signal of economic asymmetric.[40]

These weak results stem mainly from insufficient experience in business cooperation in CEE, a limited knowledge of regulatory environments and business practice among Chinese companies, and the insufficient number of investment project proposals presented to Chinese businesses. China's regional FDI is also limited by structural factors, since the number of companies with proper technology, distribution channels, and recognizable brands is relatively small.[41] Also hindering CEE countries is the fact that under BRI requirements, projects should be fully or at least substantially executed by Chinese businesses and a local government should guarantee the loan. This approach evidently promotes Chinese capital, technologies, and workers. With this model, China looks more like a lender than an investor. So even if the PRC's economic presence in CEE is much more visible today than a decade ago, 90 percent of investments in the region still flow from the United States or other EU countries.[42] Nonetheless, Chinese investments, or at least the promise of them, are starting to shape certain CEE countries' foreign policy calculations.

> "Nonetheless, **Chinese investments,** *or at least the promise of them*, are starting to shape certain **CEE countries' foreign policy calculations**."

This is most evident in the Czech Republic. Former President Vaclav Havel supported China's dissident movement and Tibet's right to self-determination, and even hosted the Dalai Lama in Prague several times. But these gestures would be unimaginable today from the current president, Milos Zeman.[43] The most visible aspect of the PRC's political influence is Zeman's 2015 nomination of Ye Jianming—who is CEFC's chairman—as his economic advisor. A company like CEFC operating in the strategically-important energy sector is almost surely private in name only and instead directed from the highest Chinese political ranks. The political dimension of CEFC's interests in the Czech Republic became public through Ye's interview with *Forbes* magazine: stressing the need for adhering to geopolitics, he warned that "if one day the Czech Republic goes against China, we need to pull back our investments to rethink our strategies there." Geopolitical considerations also appear in unusual places, such as a 2016 sister-city agreement linking Prague and Beijing: besides setting cooperation areas, the five-year accord includes a provision upholding the "One China Policy" and referring to Taiwan as an inseparable part of China. Prague, like most Western capitals, accepts that policy, but it is unprecedented to include it in such an agreement, at least in Sino-Czech relations.

China's economic influence has political implications in Hungary as well. Although the Dalai Lama visited Hungary in 2000, the country started to develop friendly ties with the PRC in 2003, resulting in a political consensus on China that today is completely free of any thorny issues for the PRC.[44] Due to Hungarian and Greek unwillingness to criticize China, the EU could not adopt a 2016 declaration noting the legal defeat of Chinese territorial claims in the South China Sea. The promise of investment by Beijing is the major reason behind the two states' behavior.[45] Hungary also backed China's efforts to be recognized automatically as a market economy despite ongoing debates in the EU.[46]

After Western European countries experienced a Chinese investment push into sensitive high-tech sectors and saw the political implications of Beijing's economic presence in CEE, they started to raise some concerns regarding China's investments in the EU.[47] This included China's "sub-regional" approach towards CEE, which was met with suspicion in Brussels and in many member state capitals.[48] Eleven of the 16 CEE countries are younger members of the EU, and there is concern that the attempt to "bilateralize" relations in this framework could risk divisions as they compete for Chinese attention, threatening EU cohesion.[49] But it is also true that China has invested much more in Western Europe than in CEE, and that these investments have also influenced some of those countries' foreign policy decisions. Examples include Denmark backing away from criticizing China on human rights issues and political dissidence, while other countries, including the Netherlands, supported granting China market economy status.[50] So China's economic presence has become a complex strategic issue for the whole EU, and since the PRC is the EU's second-biggest trading partner, with plans to spend an additional $1 trillion in outward FDI in the coming five years, Europe must develop a coherent strategy that maximizes the opportunities and minimizes the risks associated with China's presence on the continent.[51,52]

CONCLUSION

China's arrival in CEE undoubtedly adds geopolitical complexity to the region.[53] All 16 CEE countries are courting Chinese investment.[54] China's growing presence means that, besides Western alliances and a resurgent Russia very close to the region, the CEE region has a new strategic competitor. This new actor has a clear geopolitical and economic agenda—the Belt Road Initiative—which will affect European and U.S. strategic interests along the New Silk Road and in Europe.[55] Yet, even though the 16+1 is part of BRI, it is not part of Chinese grand strategy for CEE. Rather, it is more of an experiment intended to see whether this approach can further China's economic interests.[56]

China's ever-increasing economic presence in CEE requires a new approach from Europe, which traditionally has focused on Russia as its main strategic competitor. Chinese investment poses a new and unique challenge in geopolitical competition given China's vast financial resources, an authoritarian political regime that dictates its economic system, weak security relationships with Europe, and a growing assertiveness on the global stage.[57]

Two issues will be of crucial importance in China-Europe economic relations moving forward. First is the role of state-owned enterprises (SOEs), whose share of Chinese investments in CEE increased from 62 percent in 2014 to 70 percent in 2015.[58,59] SOEs and private Chinese companies operating in strategically important sectors receive preferential access to capital and other resources, thereby decreasing the competitiveness of EU-based companies bound by EU state aid rules.[60] This means that linkages among the government, the Communist Party, the military, and both SOEs and private companies—all of which have grown even more under Xi's leadership—cannot be ignored.[61] Second is the asymmetry in FDI between China and Europe. As Chinese FDI in Europe is rising, there is stagnant or declining FDI by European companies in China, which further increases the risk of even greater economic asymmetry.[62] These imbalances are mostly a result of persisting formal and informal Chinese market access barriers for foreign companies. These must also be tackled to achieve a healthy economic relationship between China and Europe.[63]

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RECOMMENDATIONS

So, if high-level acquisitions in Western Europe (KUKA Robotics, Volvo, Pirelli) and China's growing economic influence in CEE have alerted EU leaders, how should the EU react?[64,65,66] Formulating a coherent European strategy to deal with China's investment efforts will not be easy as some CEE politicians diverge from their Western counterparts and appeal to Beijing hoping to secure new deals.[67] In some CEE states, resentment toward Western Europe lingers from perceptions that Brussels regards CEE states as junior partners and does not respect their views. These feelings came to light in the debates on how to deal with Russia or solve the migration crisis, and it definitely does not help Europe in confronting the challenge posed by China. But considering the inevitable growth of Chinese investments and the trade imbalance between China and certain EU countries, it is of crucial importance for the EU—as a serious political and economic actor—to come up with a common solution to protect its interests. These include:

1) The EU should enter into an investment accord with China to replace the current bilateral agreements with an EU-wide solution. The goal should be to facilitate equal market access for European companies to previously restricted sectors of the Chinese economy.

2) The EU should establish a common European framework for screening FDI in

Europe. The European Commission (EC) began work on a proposal last September concerning primarily strategic assets critical to EU security and public order, including foreign acquisition of critical technologies, infrastructure, and sensitive information.[68] The proposal does not require member states to adopt screening systems at the state level, but ensures that states with such regimes must comply with proposed EU requirements, which facilitates greater coordination and transparency. The EC will also have the power to carry out its own screening of foreign direct investment that is "likely to affect projects or programs of Union interest," but it will not be able to block foreign investments. Jean-Claude Juncker indicated the EC intends to possibly complete the proposed framework by the end of this year, but it is unclear when the EC will approve it.[69]

3) Greater Transatlantic cooperation that facilitates more U.S. and West European CEE and Europe as a whole would also help protect European economic interests. This could better integrate CEE markets into the EU common market—a task that remains finished—and provide an attractive alternative to Chinese investment.

4) The EU must monitor and assess China's approach to investment in Europe, as well as the conditions for European investment in China. The investment model offered by Beijing so far appears focused on promoting its own geopolitical and economic interests—and less on facilitating opportunities for Europe to invest in China. The PRC must make real progress on domestic reforms that increase the role of markets and level the playing field for foreign companies. If Beijing continues to disappoint on important internal and external reforms that would increase investor confidence and security, a more sophisticated backlash against its investments in Europe seems inevitable.

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